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TAGS: ECON EFIN EUN
SUBJECT: Economic Europe: A Year of Redefinition? Or a Dangerous Cocktail?

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¶1. (SBU) Introduction and Summary: In his book "Struggle for Europe," Yale University historian (and foreign service brat) William Hitchcock describes not wars that have swept through Europe but trials and tribulations of peacetime in post WWII Europe. As the title suggests, peace does not mean tranquility. One mechanism for securing cooperation among European countries has been economic agreements: The European Steel and Coal Agreement, Customs Union, Internal Market, and, most recently, European Monetary Union. These have been defining moments in the struggle for a cohesive economic Europe.

¶2. (SBU) Among the economic developments discussed at the EU economic officers conference this fall that we will be tracking in 2004 are other potentially redefining events: the accession of 10 new member states, signature of a Constitutional Treaty for Europe, a new regulatory infrastructure for financial services, structural reforms at the national level, and negotiations on the EU budget. Accentuating these developments will be changes in leadership in the European Parliament and European Commission in the fall of 2004 and the European Central Bank (ECB) in 2003.

¶3. (SBU) It may not be too much of a stretch of the imagination to think that 2003-2004 could be one of those periods of struggle from which emerges a re-defined economic Europe. Then again, it could be just another struggle, and a nasty one at that. US interests are clearly at stake, particularly as EU and US firms are more exposed than ever before to each other's markets. A more dynamic, resilient euro area economy could help create an alternative pillar for global growth. That really would be a redefining outcome. End Introduction and Summary.

Accession Countries

¶4. (SBU) Acceding countries are scheduled to join the EU in May. Accounting for only around 6% of the euro area's GDP, they are unlikely to add any noticeable bounce to the euro area's overall economic performance in the short-term. Nonetheless, they could change the quality of the EU debates and exert indirect pressure for change. As transition economies, these countries have moved from state-controlled to market-oriented economic policies, generally appreciating the benefits of the latter. Could this portend different economic policy debates at the EU level? A German Finance Ministry official unguardedly wondered whether "old Europe" was ready for the ideas that young, well-educated economic reformers would bring to the table.

¶5. (SBU) Attracting foreign direct investment has been a boon to many acceding countries. Adopting policies that continue to do so, such as low corporate and income taxes, will apply indirect pressure on current member states to improve their own competitive position. Standing still will be a poor second best option.

Constitutional Treaty

¶6. (SBU) On the Constitutional Treaty, the Italian plan is to have a signing ceremony in Rome in May. This would be dubbed a "second Treaty of Rome," referring to the 1957 Treaty of Rome that gave birth to the European Economic Community. Building upon existing agreements, the draft Constitutional Treaty contains detailed provisions on the operation of the ECB and economic and fiscal policy coordination.

¶7. (SBU) As presently drafted, the Constitutional Treaty suggests a slight shift in power sharing on economic issues. The European Commission and Parliament would pick up new

competencies. In the area of financial services, the Commission stands to have its powers to adopt detailed implementing measures put on a firmer footing - provided Parliament is satisfied that it has a right to "call back" measures that they believe go beyond the Commission's authority.

¶8. (SBU) The draft would formalize the Euro Group, specifying areas where only members that have accepted the euro can take decisions. It also would contain an enabling clause for enhanced cooperation among willing member states. These features are already present to some degree under current arrangements. The Swedish "no" vote and the UK's failure to measure up to its self-imposed standards for euro adoption portends a higher likelihood of a multi-speed economic EU. After all, member states that have adopted the euro will be in the minority in the enlarged EU (12 of 25). Perhaps the prospect of a multi-speed EU will provide additional incentive for acceding countries to persevere in their stated desire to adopt the euro as soon as possible after accession.

Financial Services Regulatory Infrastructure

¶9. (SBU) Less obvious but potentially no less important redefining developments are the regulatory and institutional infrastructures being put into place in the area of financial services at the EU level. New committees composed of member state representatives are to give policy advice to the Commission when it exercises its authority to adopt implementing measures. Supporting those committees are other committees of experts - supervisors and technicians. This structure already exists in the securities and financial conglomerates areas and should be partially established by the beginning of next year in banking and insurance.

¶10. (SBU) By assembling supervisors from all member states, giving them defined projects that will result in EU-wide binding legislation and a mandate to ensure consistent interpretation and enforcement of that legislation across the EU - well you can imagine what comes next - an EU regulator or regulatory system. Not this year or next, but the foundation is being laid. Indeed, a group of German bankers have called for the creation of a EU supervisory authority by 2013, and the French-based Eurofi has supported a European Securities and Exchange Commission. There is a movement to have an enabling clause in the constitution to keep such an option open.

National Structural Reforms

¶11. (SBU) Another quiet, but potent re-defining development is the structural reforms being undertaken in many member states. Finally reality is catching up to the lip service and good intentions - encapsulated in Lisbon agenda and repeated annually in the Broad Economic Policy Guidelines. The anvil of slow growth and the hammer of stronger euro have forged the realization of the need for growth enhancing reforms. Germany, France, and Italy, Portugal - embarked on path others (Netherlands, Finland, Spain, Austria) have traveled before.

¶12. (SBU) Such reforms are presented not as a question of scrapping the social welfare state (or, heaven forbid, becoming "more like us" American capitalists ). Rather, as German Chancellor Schroeder shrewdly put it, "modernizing" the welfare state. Economic growth, sometimes regarded as a matter of life style (the right to more leisure and less work), is no longer optional.

¶13. (SBU) An Independent High-Level Study Group's report to the European Commission asserted that "Growth must become Europe's number one economic priority" to help integration of new members and for the sustainability of the "European model which puts a high premium on cohesion." The Italian Presidency has seized upon the issue by proposing a European Action for Growth. With some tweaking by the UK, France and Germany, Heads of State and Government should endorse the initiative by year's end.

A Different EU?

¶14. (SBU) In addition to these major or minor potentially defining developments will be other significant events in 2003-2004. The ECB will have a new President on November 1, a new European Parliament will be elected in June 2004, and in the fall of 2004 there will be new Commissioners and a reshuffling of portfolios. Taken together, by the end of 2004, the EU could be rather different in economic policy making and orientation.

Or A Dangerous Cocktail?

¶15. (SBU) Then again, 2003-2004 could be exhausted by bitter, nasty struggles and thwarted by the powerful force of bureaucratic inertia. The very ingredients that could re-

define economic Europe are also those of a "dangerous cocktail," in the words of a senior Commission official.

¶16. (SBU) The Inter-Governmental Conference charged with finalizing a Constitution for Europe will be composed of acceding countries as well as member states. This would be, in the view of one observer, the "first serious test" of the enlarged EU's readiness to demonstrate the art of negotiation and compromise, putting aside national interests for European ones. The Italian Presidency, Germany and France have cautioned against opening the draft text. This smacks as a fait accompli. Voting rights, under terms of the draft, would favor "charter" members, not Spain and Poland.

¶17. (SBU) By flouting the Stability and Growth Pact rules and the Treaty's requirements on budget deficits, France is suggesting that acceding countries sign on to our rules which apply to others, but not ourselves. Not very community-like. Fudging the SGP rules could lead to the same fuzzy math for the Maastricht criteria for acceding countries' adoption of the euro. Not necessarily a comfortable turn for the euro.

¶18. (SBU) Dissension over the draft Constitution and Stability and Growth Pact disciplines could be exacerbated by negotiations on the EU's budget perspectives for 2007-
¶2013. The Commission plans to have a "political framework" agreed by the end of 2003. It faces serious headwinds. Acceding countries are vying for shares of structural funds while current members try to hold on to as much as possible, either structural funds (like Portugal and Spain) or special rebates (like the UK).

¶19. (SBU) Linkages between issues -- the constitution, the SGP, budget, regulatory infrastructure, and policy measures, are more than likely - if not direct then indirect. Losing on one front could mean getting even on another. Taken together, a pretty volatile mix. (Note: While this cable is confined to economic issues, several commentators have suggested that political issues being closely watched by others will also determine whether the EU undergoes a redefining moment or loses its way from imbibing the dangerous cocktail.)

US Interests

¶19. (SBU) The United States continues to have a strong interest in an economically strong, vibrant Europe. In his "Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy, " Joseph Quinlan arrays data to demonstrate that Europe and the US are more economically interlinked than ever before. "The reality is that Europe, on account of its deep investment roots in the U.S., is far more exposed to U.S. economic conditions than any other region of the world. A similar commitment of investment goes in the other direction. 58% of corporate America's foreign assets are in Europe with U.S. foreign affiliate sales in Europe accounting for more than half of their sales worldwide." He believes that the "common ground between the U.S. and Europe is still fertile for further economic integration."

¶20. (SBU) Areas in which Quinlan suggests integration could be undertaken include corporate governance and financial regulatory standards, the very areas in which EU regulatory infrastructure is being created and on which the US and EU have an informal dialogue. Structural reforms, fiscal discipline, the Constitutional Treaty and entry of accession countries could combine to affect US interests - for better or for worse. A positive outcome for both the EU and the US would be a more dynamic EU economy more resilient to economic shocks, generating more domestic demand. This would help create an alternative pillar for world economic growth. Now that would be a re-defining outcome for Europe from which the global economy could benefit.

¶21. (U) This cable coordinated with Embassies London, Berlin, Rome, Paris and USEU.

¶22. (U) POC: James Wallar, Treasury Representative, e-mail wallarjg2@state.gov; tel. 49-(69)-7535-2431, fax 49-(69)-7535-2238.

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